

FEDERAL HOUSING FINANCE BOARD

BOARD MEETING

OPEN SESSION

Wednesday, March 8, 2006
Washington, DC

The Board meeting convened, pursuant to
notice, at 9:59 a.m., at 1625 Eye Street, N.W.,
Washington, D.C.

MEMBERS PRESENT

RONALD A. ROSENFELD, Chairman
FRANZ S. LEICHTER, Director
ALICIA CASTANEDA, Director
BRIAN MONTGOMERY, Director
ALLAN I. MENDELOWITZ, Director
SHELIA S. WILLIS
JOHN P. KENNEDY
STEPHEN M. CROSS
SCOTT L. SMITH
TOM JOSEPH
TONY CORNYN
CHRIS MORTON
CHRIS BOSLAND
CHUCK JONES

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ANNA WATSON

P R O C E E D I N G S

CHAIRMAN ROSENFELD: Good morning, everyone. I call this meeting of the Federal Housing Finance Board to order.

Today, we will have an open session followed immediately by a closed session where the Board will receive updates of examination and supervisory findings.

We now need to vote to approve closing the latter portion of today's meeting, as required by the Sunshine Act and Finance Board regulations.

And since the closed portion of today's meeting will contain sensitive and confidential bank examination information, I would ask for a motion to seal the transcript of this portion of the meeting. Director Castaneda?

DIRECTOR CASTANEDA: Mr. Chairman, I move to close that portion of this meeting and further that this Board determine that the record and transcript of this closed portion of the meeting be kept confidential.

CHAIRMAN ROSENFELD: Thank you for the motion. Is there any discussion of the motion? Any discussion?

Seeing none, the Secretary will please call the roll on the motion?

SECRETARY: On the item before the Board, Director Leichter, how do you vote?

DIRECTOR LEICHTER: Yes.

SECRETARY: Director Castaneda?

DIRECTOR CASTANEDA: Yes.

SECRETARY: Director Mendelowitz?

DIRECTOR MENDELOWITZ: Yes.

SECRETARY: Director Montgomery?

DIRECTOR MONTGOMERY: Yes.

SECRETARY: Chairman Rosenfeld?

CHAIRMAN ROSENFELD: Yes. The motion is carried and the subsequent portion of our meeting will be closed and its transcript will remain closed and confidential. Thank you.

Let us now turn to the public portion of today's meeting. The first agenda item for consideration is a proposal to amend and add to the

agency's capital regulations for the Federal Home Loan Banks. Like any head of a bank safety and soundness regulatory agency, I and my Board colleagues spend a great deal of time and energy thinking about safety and soundness, corporate governance, and capital adequacy.

It should come as no surprise that these days at the Finance Board, we are nearly consumed with these matters. Each one alone is critical to the success of a financial institution, especially a government-sponsored enterprise.

At this meeting, we are considering proposals to amend and add to the agency's capital regulations for the Federal Home Loan Banks. The proposed amendments deal with retained earnings and excess stock.

Today, we have in place Supervisory Written Agreements with two banks. At one of those banks, Seattle, the underlying problems could have been avoided if the bank had built and maintained adequate levels of retained earnings, as in fact were done at a different bank, New York.

In the second bank which is Chicago, one of the most significant underlying problems giving rise to the Agreement was the bank's reliance on voluntary or excess stock for its capitalization.

In other banks, excess stock, while not necessarily contributing to imprudent financial decisions, has contributed to inflated balance sheets and increases in assets that are not critical to the banks' core mission.

It is clear from these cases that we must take regulatory action to minimize the potential for undue risk-taking in these government-sponsored enterprises. That is, after all, the primary responsibility of this agency. We have experienced some difficult situations over the past several years. They are experiences from which we must learn to avoid their recurrence in the future.

We have in the past tried less formal supervisory approaches. The Office of Supervision, for example, issued an Advisory Bulletin in 2003 regarding capital management and retained earnings. However, the banks' responses have generally been

less than satisfactory and certainly uneven. Thus, we are left with a regulatory approach.

Now, I would like to turn to Steve Cross to present the case. In presenting the case, I specifically request that you explain not just what is being proposed at this time, but how these proposals may fit into a broader and more comprehensive plan to address our capital regulations.

After hearing the presentation, I would invite my colleagues to offer their views as well. Dr. Cross?

DR. CROSS: Thank you, Mr. Chairman, members of the Board.

I'm presenting a proposal to you today to amend Parts 917, 925, 930, and 931 of the Finance Board Rules and to add a new Part 934.

The proposal would limit a Home Loan Banks' reliance on excess stock as a source of capitalization and would establish a regulatory minimum level of retained earnings at the twelve Federal Home Loan Banks. The amendments would

address conditions among the Banks that have given rise to formal and informal supervisory actions in the past two years by strengthening the composition of capital at the Federal Home Loan Banks.

The proposals before you would be issued for a 120-day comment period. Let me speak first about the proposals dealing with excess stock. The proposed regulatory amendments would limit excess stock in any bank to no more than one percent of its assets. It would prohibit members from purchasing capital stock in excess of the required stock. And it would prohibit banks from paying stock dividends to their members.

We propose these amendments for both safety and soundness and public policy reasons. Since banks often repurchase excess stock from a member promptly upon request, a bank's reliance on excess stock could create capital management challenges for a bank if it were to experience substantial member requests for repurchase or redemption over a relatively short time period.

In addition, the banks' status as government-sponsored enterprises permits them to borrow funds at favorable rates and invest proceeds in non-mission related assets, most notably mortgage-backed securities and money market instruments. While these activities may increase bank income, they do not directly further the bank's public purpose.

In summary, the limit on excess stock should reduce the potential for capital instability at the banks and limit the use of excess stock as a funding vehicle for non-mission related assets.

Let me next talk about the proposals with respect to retained earnings. The proposal would establish a minimum retained earnings requirement. The proposal to establish a minimum earnings requirement would require each bank to hold retained earnings of at least \$50 million, plus one percent of non-advance assets.

Second, it would limit dividends, except with the approval of the Finance Board, to no more

than 50% of net income until a Home Loan Bank attains its required level of retained earnings.

Third, it would restrict, except with the approval of the Finance Board, payment of any dividends thereafter if a bank's retained earnings drops below its required level. And fourth, it would permit a bank's dividends in any quarter to be declared only after the bank's net earnings for the quarter have been recorded.

At present, all twelve Federal Home Loan Banks exceed their minimum capital requirements. And the risk of capital insolvency for any Federal Home Loan Bank is extremely remote. However, the capital stock of a Federal Home Loan Bank has characteristics that require its par value to be fully protected. Therefore, one of our principal supervisory and regulatory objectives has been to build retained earnings at the banks so that they can absorb unanticipated losses without depleting retained earnings in order to protect the par value of their capital stock.

In an effort to encourage the Home Loan Banks to bolster their retained earnings, as the Chairman indicated in his remarks, the Office of Supervision issued Advisory Bulletin 03-08, *Capital Management and Retained Earnings*, in August of 2003.

That Advisory Bulletin required each bank to adopt a capital management and retained earnings policy that includes a retained earnings target commensurate with the bank's risk profile under a variety of economic and financial scenarios.

We have been critical of bank retained earnings and capital management policies in our examinations and have found that the methodologies used to determine retained earnings targets often lacked analytical support and justification.

The proposal would establish a more consistent framework and a regulatory basis for assessing banks' retained earnings. The formula would establish a base of \$50 million of retained earnings that is designed for truly unanticipated losses.

In addition, a bank would hold retained earnings equal to one percent of non-advance assets. That's because we believe the most significant risks faced by the Federal Home Loan Banks generally are associated with non-advance assets, such as mortgages, mortgage-related securities and the hedging and funding instruments associated with those assets.

Further, advances differ from other bank assets in that member institutions normally must purchase capital stock known as activity stock in support of advances. Stock in the Federal Home Loan Banks held by the member is available to absorb credit losses incurred from advances and other indebtedness of a member to the bank.

In making this proposal, there's no question about the capital solvency of any Federal Home Loan Bank. The proposal is designed to address the composition of the capital. That's what gives rise to this proposal.

Finally, Mr. Chairman, you asked that I talk about future changes to capital requirements and let me do that at this time.

The proposed minimum retained earnings requirement should be viewed as a first step toward better aligning a bank's minimum retained earnings requirement with its risk exposure. Going forward, we intend to explore the development of a more refined approach to setting minimum retained earnings requirements, one that would be more risk sensitive than the one being proposed today.

In addition, we plan to explore and develop a proposal for a more robust risk-based capital requirement. Over the next 12 to 18 months, we will be considering amendments to the risk-based capital rule that would update and streamline the market risk component of the risk-based capital rule. It would replace the existing 400 scenario approach with a simpler, more limited approach that would still cover a wide range from our perspective, a full range of interest rate and economic scenarios to which the banks might be subject.

Secondly, we expect to update the credit risk component -- the so-called credit risk weights -- to conform with the Basel II proposal, assuming that the other U.S. bank regulatory agencies officially adopt the Basel II framework.

Third, we expect to update the operational risk component to better align with the Basel II proposal. And fourth, we are looking to at least consider changing or amending the requirements that the Finance Board must pre-approve any changes or any substantive changes to the market risk models of the Home Loan Banks. Instead, we would look at evaluating any changes as part of our examination process which we do today.

In considering ideas for improving our retained earnings and risk-based capital requirements, we plan to review best practices and explore alternatives with the banks, other regulators and other market participants.

Mr. Chairman and members of the Board, that concludes my presentation. I'd be happy to respond to any questions or comments.

CHAIRMAN ROSENFELD: Dr. Cross, thank you very much. Do any of my Board member colleagues have any comments?

DIRECTOR MENDELOWITZ: Sure. First, I'd like to say that I take great satisfaction from seeing that the issue of strengthening the capital structure of the banks is on the agenda for Board consideration.

The issue of necessary required retained earnings is something that I raised soon after I arrived at the Board in early 2001, and it's been a concern of mine every since. And I think, Steve, you've done a great job of laying out the objectives and the considerations as to why we need more retained earnings in the system.

The fact that the banks don't have adequate retained earnings is more a function of the public policy perspective and responsibilities that the Board has as distinct from the individual Boards at the banks. And I think that everyone looking at this issue would do well to consider your comments carefully and to read the preamble to the proposed

rule because I think it lays out in a very clear and easily understandable way why more retained earnings are important to the system and the ability of the system to fulfill its public policy mission.

So I sort of state that by preface because the questions that I have really are issues related to sort of tidying up things around the edges or answering questions that are still open in my mind as we move forward as to what a final rule should look like.

The first is the issue of a simple formula versus a risk-based analysis for the retained earnings objective. Whenever you have a complex problem and there's a simple solution for it, I'm always reminded of that folk wisdom that invariably is correct when it says for every complex problem, there's always a simple, easily understandable solution that's invariably wrong.

So the fact that we have a simple solution, I want to make sure that we in fact have the best solution and we get to where we want to get.

And in that light, I have a question for you which is, if we have two typical banks -- let's assume the system has two banks. One bank has 50% of its balance sheet in advances and 50% in mortgage instruments. The second bank has 50% of its balance sheet in advances and 50% in overnight fed funds. And let's say they both have \$100,000,000 on the balance sheets, so they're the same size banks. Is the risk profile of those two banks the same?

DR. CROSS: No.

DIRECTOR MENDELOWITZ: Can you tell me a little bit how they differ?

DR. CROSS: Well, obviously, a bank that has mortgages has substantially more exposure to market risks. Mortgages are subject to prepayment at the option of the borrower and so the bank is in a position in which it must fund those mortgage activities with debt that, as hard as they try, won't exactly match up in terms and conditions with the mortgage.

Therefore, if mortgage prepay either faster or slower than anticipated, there's a chance that as

interest rates move up or down that the bank may either have greater income than would have otherwise been expected or lesser income. In other words, they are exposed to variability of income that does not exist with short-term triple A, double A rated funding instruments.

There is presumably some greater credit risk in addition with the mortgage portfolio, although the credit risk in the mortgage portfolio of the Home Loan Banks is substantially limited by the extensive set of credit enhancements that are part of both the MPF and MPP programs.

Finally, there are, of course, greater operational risks in the mortgage program because of the need to combine and coordinate both the funding and the asset activities. So clearly the bank that has the mortgage portfolio is more risky than the bank that has the portfolio that is overwhelmingly in short-term capital markets instruments.

That said, I think that's a good point, and that's why we are looking to refine risk-based capital. It's why, as has been suggested, and I

want to recognize the work that Scott Smith, Tom Joseph and Tony Cornyn have done on this proposal and in our thinking about where we go forward, why consideration of income volatility at the banks is an important consideration as we look to refine the risk-based capital proposals.

So I accept the basis for your question, and I think there's a valid point to be made there. I think that in giving this proposal, our belief is that we have done the following.

We have selected a framework based on some econometric analysis that we did that is designed -- that fits reasonably well our measures of risks associated at the twelve banks with, as you suggest, a rather simple formula. The fit is reasonably good. That's a starting point.

In addition, we built in the principal that for purposes of safety and soundness, we could increase the retained earnings requirement. That was done because we felt that, rather than establish a requirement that would capture the -- you set up a stylized example -- the situation in that example of

a bank that is heavily invested in mortgages, we felt that we could in that case, which probably would not fit as well, that particular case would probably deviate from the fitted line.

We could, through our supervisory program for safety and soundness purposes, require an increase in the retained earnings of that bank above the level suggested by the formula.

That said, I acknowledge the points you made.

DIRECTOR MENDELOWITZ: Yeah, the concern I have is that when you come up with a formula like \$50 million plus one percent of non-advance assets and you're basing it upon a simple linear regression, what you're doing in effect is you're taking an average and you're applying the average to all the banks.

And you know the joke about what an average is. It's a guy who's standing there with one foot in a bucket of ice water and one foot in a bucket of boiling water, but on average, he's okay. And that was what I was trying to capture with the two

stylized examples because the reality is is you've explained the different risk profiles. The bank that has half mortgages and half advances has far more credit risks and in particular, market risks than the bank that's half advances and half overnight fed funds.

And so that we've averaged the two and we've come up with a formula. So this formula basically says the bank that's half mortgages, half advances, based on formula, won't have enough retained earnings. And in fact, the bank that's half advances, half overnight fed funds will have too much.

And this concerns for me for two reasons. One is that I'm concerned about the bank that too much risk -- I'm sorry, not too much, but has more risk, not having enough retained earnings. And I'm concerned about the incentives that the formula will give to the banks because the bank over here that's a low-risk bank will say, gee, I have to have more retained earnings in my true risk profile and I'll just put more risks on my balance sheet. I'll make

more money, and if I'm going to have to put the retained earnings in, I might as well take on more risks. And that's kind of a perverse incentive.

DR. CROSS: That's -- I don't know that either of us can say that this retained earnings proposal would incent the banks in the way that you described. The ramifications with respect to retained earnings -- let me say it this way. Today, arguably the same circumstance exists, that there is no regulatory minimum retained earnings, so there is no regulatory basis for requiring more retained earnings with a greater risk profile.

So I don't see that adopting this rule would intensify that perverse incentive over the status quo.

DIRECTOR MENDELOWITZ: Good, thank you. This issue of, to follow on substituting a simple formula with a risk-based analysis linked to risk-based capital, I'm really encouraged by that sort view of the horizon because I really believe that is the correct way to go. There's no question in my

mind that the state-of-the-art in assessing risks is pretty well developed.

We have a much more sophisticated and perfect approach to evaluating risks for risk-based capital purposes. I think we can improve on it significantly and I think we can improve on this proposed formula by coming up with a better risk-based capital formula and linking the retained earnings requirement to that risk base. So I would strongly encourage you to move as expeditiously as possible.

Do you think you could have a proposal ready before the end of the year? And I'll tell you why. It's because I believe in Boyle's (ph) law of getting things done. Work expands to fill whatever timeframe is there, and instead of setting an 18-month time horizon, supposed you set a 9-month time horizon so we can get it done by the end of the year. Do you think it's possible?

DR. CROSS: I think it is possible to -- I think it's possible to do this in nine months. I laid out a 12 to 18-month timeframe. I think our

thinking internally with respect to market risks is quite far along. What we want to do with respect to market risks is essentially share our internal thinking with other regulators, the banks and other large financial institutions to test that.

The principal time I believe in developing a proposal more closely linked to risk-based capital or income volatility involves two parts. One, testing our thoughts about market risks, appropriate market risk measure and resolving some questions that we have internally about the advantages of focusing on valuate risks through a more limited scenario analysis versus income volatility as the driver for the risk-based capital.

So to quote you, it's important to do the right thing and to do it right. I'm probably paraphrasing here.

DIRECTOR MENDELOWITZ: No, you got it pretty close. Do the right thing and do it the right way.

DR. CROSS: And so want to -- we could develop proposals in a very short period of time.

We want to subject them to external review before we come to the Board. But end of the year target, early in the following year. That's a reasonable timeframe for us to be looking at.

DIRECTOR MENDELOWITZ: Great. The reason why I am pushing you on this is that if you set a 12 to 18 month time horizon, it won't get done in 9 months. If you set a 9-month time horizon, it might get done in 9 months and it's even more likely that it will get done in 12 than if you set the 12 to 18-month time horizon.

So I would really encourage you, in working with your staff and balancing all the multiple things that you have to sort of balance and get done, if you could shoot for the earlier deadlines of 9 months, I would find that very helpful. Thank you.

DR. CROSS: Well, as a career bureaucrat, speaking of myself, --

DIRECTOR MENDELOWITZ: Civil servant.

DR. CROSS: -- obviously I have an objective to meet or exceed the deadlines that are

in front of me, so I set the 12 to 18. We will amend it to 9 to 12.

DIRECTOR MENDELOWITZ: Sounds good to me. Having been a charter member of the Senior Executive Service, I remember we entered into our first negotiated contracts in the Senior Executive Service, and we had to set targets and deadlines. And we sat down and came up with a series of proposals that we knew we could make and we sent them up to the agency head and they came back down considerably shortened and considerably tighter.

Next question, I am very sympathetic to this notion of limiting excess stock, and the justification for the one percent seems reasonable. But is there any other analysis that you are undertaking to try to refine the basis for what the limit is?

DR. CROSS: That is something I believe that we should do, certainly during this comment period because we need to be prepared for whatever comments we receive.

As is indicated in some of the written material that you have and will be made available to the public when we complete all technical and conforming changes, assuming that the Board acts to approve us, publishing in this Federal Register, will be made available to the public as soon as it's sent to the Federal Register.

We know that four banks currently exceed the excess stock limitation. We know that if we look at the system as a whole and we look at MBS and other capital markets and short-term investments, that establishing an expectation that in effect they not exceed approximately 25% of the total assets of the banks, seems to be a limit that most of the banks can live well within that limit.

So in that sense the limit was not meant to be in effect binding on the average Home Loan Bank. It was intended to address outliers among the Home Loan Banks.

Refining it, and this is an issue that has been under substantial discussion, in light of the role that excess stock plays as the capitalization

for unsecured credit and MBS is something that we should and will do if the Board wishes for us to establish not in effect an outside limit that is meant to address outliers, but rather establish more of a target to which to banks should operate.

The current proposal really establishes an upside limit to address the case of outliers rather than establish a target level --

DIRECTOR MENDELOWITZ: An effective system --

DR. CROSS: -- that might more clearly reflect, for example, the level of liquid assets that we think the banks need for liquidity purposes as opposed to arbitrage purposes.

DIRECTOR MENDELOWITZ: From both a safety and soundness and public policy perspective, you've provided, I think, a good basis for why we would want to put a limit like one percent.

One comment I have though is that there are unintended consequences. Are the Home Loan Banks a large enough portion of the fed funds' market so that if there was substantial reduction in the

availability of fed funds from the Home Loan Banks to other participants that it could in fact affect the liquidity of the fed funds' market?

DR. CROSS: I don't know if Tony or Scott - the Home Loan Banks probably account for 100 to 115, and actually sometimes below 100 -- say 85 to 115 to 20 billion dollars of very short-term unsecured credit, such as fed funds. I don't know, Tony or Scott, if you know -- if you have the data with you. I'll be happy to check on that, obviously, if they don't have it.

DIRECTOR MENDELOWITZ: I understand that that's not information that you necessarily have at your fingertips, but I think it's something we should look at to make sure that we don't create an unintended ripple someplace.

MR. SMITH: I would certainly think that implications of the proposed rule would have not significant or immaterial effects on it.

DIRECTOR MENDELOWITZ: Next question in terms of how you define excess stock. The proposed

rule defines excess stock from the perspective of the individual member, not in the bank.

And as you point out, one of the banks has a capital structure that loans capital from one member to another if there's excess stock on the part of one member and a requirement for stock on the part of another. And I don't recall the details of that capital plan. But if that capital plan basically says if Bank A loans shares to Bank B and as long as Bank B needs those to capitalize an advance or some other activity, Bank A can't get it back. Is it truly excess then?

MR. JOSEPH: I don't believe their plan says that. I think they are subject to the same limits of other banks, that the bank couldn't buy back the stock if it would go below its minimum capital requirements, but the pool of excess stock doesn't run from a single member to another member. It's just pooled collectively.

DIRECTOR MENDELOWITZ: If they change their plan then so that in fact the loan stock is basically stable and won't be pulled back because

they changed their plan to say once it's loaned out, you can't get it back, so it's no longer supporting an activity, would you consider that excess stock to be unstable then?

DR. CROSS: Well, let me start by stating that such a change in their capital plan would be subject to the approval of you and the other four members of the Finance Board and would be subject to analysis and recommendations from us. I don't -- my initial reaction is that I would not be inclined to recommend to the Board that those amendments be accepted for a variety of reasons.

DIRECTOR MENDELOWITZ: You don't have to pre-judge any hypothetical change, but I'm just --

DR. CROSS: The problem I would have -- I'm not going to answer your question exactly as you asked it because fundamentally, that would create a situation that, for reasons other than meeting a capital requirement, the bank would in effect refuse to honor redemption requests of its members. And I think we have to be very, very wary about going down that particular path.

Clearly, though, it changes the dynamic with respect to stability or instability of the capital stock, although part of the dynamic is with respect to member expectations. Will members change their behavior if they no longer believe they will be able to receive their capital upon request? And there, I believe, the capital plan amendment could itself create some instability.

DIRECTOR MENDELOWITZ: Okay. That's a good point. Moving on to the issue of stock dividends, how long have the banks been paying stock dividends?

DR. CROSS: Well, our board cases references that they've been paying them at least since 1995. I don't know, Scott, if you knew that they were back beyond that.

MR. SMITH: I do think they go back before that but that's as far as we checked.

MR. JOSEPH: There's no limitation in the statute on the form of what dividends can be paid in, so conceivably it could have gone way back.

DIRECTOR MENDELOWITZ: The issue of stock dividends -- the primary reason why the banks pay

stock dividends is because there are tax advantages. Banks don't have to pay recipients of the dividends and don't have to pay taxes until that stock is redeemed or repurchased. Was that ever tested in court, whether this is a perfectly legal and appropriate use of the tax laws?

MR. JOSEPH: There were, I believe, two cases -- one in the Ninth Circuit and one in the Seventh Circuit, but don't quote me on the circuits. And in both times, the IRS lost and the court said that the tax deferral was appropriate under the law.

The issue, I think, arose on whether you were actually giving the members the option to receive either the dividend in the form of stock or in the form of cash because of the new purchase redemption feature of the stock. And because the bank maintained discretion not to immediately repurchase, the court said there was no choice on the part of the member. I do believe that was the legal reasoning.

DIRECTOR MENDELOWITZ: So the legality of it has been tested in court. Did the IRS or the

Treasury Department do anything after losing the court cases?

MR. JOSEPH: I don't know. They did issue, I think, a letter saying they were going to accept the court ruling, I believe, but I don't know anything beyond that.

DIRECTOR MENDELOWITZ: Was there any effort to get legislation passed to prohibit this?

MR. JOSEPH: I don't know. I mean all this, I believe, was well over -- can't remember, at least 10 or 20 years ago.

DIRECTOR MENDELOWITZ: Well, for sure -- well, we only have data going back to '95. No, the reason why I asked is that our statute has been opened -- do you remember the years of these cases?

MR. JOSEPH: I'll have to check the cases. I don't remember if it was in the '80's or the '90's.

DIRECTOR MENDELOWITZ: Right, because basically our statute was opened not that long ago. A number of changes were made to our governing

statute. The Congress, if it wanted to take away this tax benefit, had ample opportunity to do it.

And the fact that this has been tested in court and Congress has opened the legislation and chose not to prohibit this practice makes me a little uncomfortable with doing something that appears to be usurping congressional prerogatives.

Whether you like or you don't like the tax benefit on a personal basis, as a regulator, I don't think we can behave arbitrarily and capriciously. And as a regulator, I'm very leery of doing anything that appears to usurp congressional prerogatives. And so, I mean, I'm comfortable with setting a limit on the amount of excess stock. I think we have a sound safety and soundness reason for doing it.

If a bank is at the excess stock level that is below the limit that we set by regulation, I think we're on very thin ice when it comes to trying to prohibit stock dividends. There's a natural limiting process here when you bump up against the excess stock limit, and I'm actually quite uncomfortable with trying to, by regulation, repeal

something that has stood the test of court challenges and that Congress chose not to overturn when it opened our statutes.

So I'm looking forward to getting comments from the interested parties and affected parties who read this proposed rule on the appropriateness of putting in a prohibition on stock dividends.

Going to the transition period, is there a -- I can't remember the exact -- when I read the memos versus the wording of the preamble, but is there in the preamble a request for comments on the stock dividend? It's there, okay, good.

DR. CROSS: It's on page 12 of your --

DIRECTOR MENDELOWITZ: Right, right. Now that you mention that, I see in my notes here, I put down page 12, request comments. Thank you.

DIRECTOR MENDELOWITZ: Going to the transition period, the objective is to get a timely build up and required retained earnings. How do we define timely?

DR. CROSS: I'm sorry, would you repeat that question?

DIRECTOR MENDELOWITZ: The objective of the limit on dividends during the transition period is to achieve a timely build-up or appropriate level of retained earnings. How do you define timely?

DR. CROSS: Well, most of the banks will achieve their target within a year and a half to two and a half years. With one exception, they would all achieve their target in less than three years. So my answer would be in less than three years.

DIRECTOR MENDELOWITZ: The income of the Home Loan Banks is highly correlated to prevailing interest rate levels. When interest rates go up, Home Loan Banks with a lag make more money. When interest rates go down, Home Loan Banks with a lag make less money.

This projection of how long it will take is based upon just a straight-line projection of 2005 earnings. And given that it's reasonable to assume that income is going to go up, they should reach the targets much sooner than the straight-line estimates. I think it's reasonable to assume income

should go up in the system because interest rates are going up.

And that goes back to the issue of what are we trying to do here. What we're trying to do is build retained earnings so that in the event of a going concern loss, we don't have a crisis. If you have enough retained earnings, if you experience a loss as a going concern, you can absorb that loss without a hiccup and keep moving.

And we define the crisis as being, first and foremost, an impairment of stock, the impairment of the par value; secondly, an interruption in the ability to repurchase or redeem stock; and third, a suspension of dividends.

And one of the things I'm concerned about is that as we move to a system change -- we're talking about a structural change. This really is a structural change. We are changing the composition of capital to make this system more resilient to unforeseen losses and to make the system more resilient from a public policy perspective. You can

hit a blip and just keep going without having ratings affected or anything else.

In making that structural change, I'm concerned that we don't up-end the value proposition of being a member of the system by skewing things too heavily one way or the other. And I do have a concern that the 50% payout limit during the transition period is such a serious reduction in the ability to pay dividends that it does sort of -- has the potential for creating almost the kind of problem that we're trying to avoid by building up retained earnings. And we need to get from here to there in an appropriate way.

In the analysis that your staff has done, doing just straight-line projection of 2005 income, if the maximum payout were increased from 50% to 60%, all banks, save one, would get to the target within three years. If the maximum payout were increased to 70%, again save one bank, all the banks would basically get to their target in four years.

Now, given that we're talking about making a structural change in the system rather than trying

to deal with the crisis, I'm particularly sensitive to the fact that as we make the structural change, we don't do anything that makes it look like a crisis. Putting a cap on a payout of 70% from my perspective, moves the system toward a timely accumulation of the necessary retained earnings and at the same time, it doesn't create enough of a crisis to up-end anything operating in the system.

And so I'd very much be interested in getting comments from commenters as to what they think is a defensible and appropriate level of restriction on dividends.

Secondly, as an alternative to a quarterly restriction on dividends, we could have a transition period and basically tell the banks, you've got three years or four years to reach your target. If you don't reach it in that three or four years, you're going to be really put upon by us. We're going to do really dire and serious things to you. But in terms of how you -- the pace at which you accumulate, it's up to you. You manage complex, large financial -- each of you manage large, complex

financial institutions and you should be able to manage accumulation over the transition period.

I have to say, I am at this point agnostic as between whether a dividend limitation or a fixed transition period is preferable, although based on some briefings I got from the staff, I'm sort of inclined more toward to dividend limitation, but I don't want to dismiss the possibility of a fixed transition period. And I know we asked for comments on that, and I'm looking forward to seeing what kind of comments we get on that.

DR. CROSS: We do ask for comments, and I could just add that the limitation is not a hard cap. It's a cap that can be overcome if a bank requests and makes a case for a payout in excess of 50%.

As you know, as the banks have been working their way through the SEC registration process, we have established an expectation on the part of the banks that they must get our approval before paying dividends, and the basis being that without audited financial statements, we can't be certain without

some analysis that they are paying dividends out of current earnings and retained earnings which is our statutory responsibility I think.

This is a little bit different, but during that period of time, in effect, banks have been unable to pay dividends without prior approval of the Finance Board. We have done that and banks have consistently been able to pay dividends. At times, they have not been as high as the banks initially proposed, but in all cases, they have been able to pay dividends. They have gotten responses in a timely fashion.

And so I simply suggest that the opportunity to pay in excess of the limit with prior approval of the Finance Board by our past practice is not empty words. We will -- our anticipation is to do that. That said, you are absolutely right. You raised good questions about both the level at which the limit should be established and whether the limit should be established as a payout rate or a time period. And I think that sort of points out

the inherent beauty of the proposed rulemaking process.

DIRECTOR MENDELOWITZ: I have to say that I would look favorably on a fixed transition period only if the penalty for being out of compliance at the end of the period was so severe that there would be no incentive to game the system. So we should keep that in mind.

In the proposal, you would have the banks reassess their required retained earnings minimum every quarter based upon the daily averages outstanding. Do we lose anything if we go to a once a year or once every six months rather than every quarter developing a new target? And again, it's an information request, I don't know.

DR. CROSS: We looked at doing it once a year with it basically in mind the bank could plan for the whole year what its target would be. We ran some numbers based on historical levels, and I will say, my biggest concern -- and Scott or Tony are free to speak up if they wanted to add to this -- my biggest concern was that the banks are growing.

And as the banks grow, basing it on either end of year or quarterly averages of the previous year when our preliminary analysis was based on something more current, I felt that it was leading us to consistently lower target numbers that might not be as consistent with what was underlying the admittedly, rather, simple linear regression on which the proposal is at least partly based.

So, yes, the short answer to your question is that is another variable that could be considered in the assessment -- how frequently the number is updated. The final thing I'll say, though, is that for ease of calculation, we used either average daily balances within a quarter which is a call report generated number. So it's an easy calculation. It can be calculated within the first fifteen days or so of a quarter and governs where the bank must be at the end of the quarter.

DIRECTOR MENDELOWITZ: Great, thank you. Next question, when you -- just a quick question about excess stock, and I'm not sure I understood the proposal exactly.

The banks typically when they require the purchase of activity-based stock, usually round up so they don't wind up with \$2.37 worth of capital. You can correct me if I'm wrong, but I'm under the impression that when an activity-based stock purchase is made, it's usually in round lots of \$100 or something like that or \$1,000. I don't remember which it is. But they never require less. They always more. They round up to the next whatever traunch of capital that's required to be purchased.

Is there anything about this rule that would -- the limit on either excess stock or the prohibition on selling stock that isn't activity based, is there anything in this rule that would prevent banks from doing what is a perfectly reasonable, from an accounting perspective and a bookkeeping perspective, rounding up when selling up when selling activity-based stock?

DR. CROSS: What you described is a perfectly reasonable practice. And if there's any -- there's nothing in the rule intended to alter that practice. If we were to determine through the

comments received in the comment period and that kind of scrutiny of the language, that the prohibition against the purchase of stock that is excess at the time of purchase would be construed to limit the ability of the banks to do that, we would certainly want to change the language so as to not have that outcome.

DIRECTOR MENDELOWITZ: Moving on to what happens after the transition period, first question is if we stick with a percentage, do you see a benefit to having a permanent restriction in place which is once you get to your required retained earnings level, do you still have to keep adding 5% of your income or some relatively small amount to retained earnings?

Under the old capital structure, banks had to put 20% of their income into retained earnings until the retained earnings equaled half of their required capital or something like that.

MR. JOSEPH: I think it's equal to par value.

DIRECTOR MENDELOWITZ: Equal to par value, right. So it would basically equal half the balance sheet. Would you see any benefit to having sort of a permanent injunction like that? Injunction is probably not the right word -- a permanent requirement that at least some small amount of retained earnings is permanently added -- a certain amount of income is added to retained earnings each quarter?

DR. CROSS: Well, Director Mendelowitz, my job is to insure the safety and soundness of the Home Loan Banks. There is -- I'm in love with retained earnings. There's nothing that would cause retained earnings to rise that I would argue against.

That said, that's a fundamental change that could, I think, be argued to run counter to existing statutory language that says dividends may be paid out of current income or previously-retained earnings. Under the circumstance you described, you could never be paying dividends out of previously retained earnings, so I'll leave it to the lawyers

as to whether or not we would working at cross purposes.

DIRECTOR MENDELOWITZ: Yeah, that sounds reasonable. I'll withdraw the proposal. I hear sighs of relief from our guests in the audience.

Moving on to the post-transition period, the current proposal says you can't pay any dividends without Finance Board approval if you pierce the required earnings minimum.

And one of the things that I'm concerned about here is that we have two events. One event is impairment of the par value of the stock which has very serious consequences in the marketplace with respect to the regulators or the member institutions, with respect to the rating agencies, with respect to counter-parties, the regulator's transaction with respect to how the members view this, how their auditors may view it.

And so piercing the par value of the stock has serious consequences which we want to avoid like the plague because as you articulately laid out in your opening review of the proposed rule, this would

put the system at risk in terms of its ability to fulfill public policy, housing and finance mission.

But if we change the composition of the stock and put in a required retained earnings minimum that in fact puts a cushion between the capital level and the par value of the stock, I don't think that piercing the required minimum should trigger the same kind of events that we're trying to avoid if the par value of the stock gets pierced.

The example I like to give is from the "Top Gun" movie, when you go out and you train fighter pilots. If the fighter pilot in training pancakes into the ground, that's a pretty serious outcome. He's gone, the plane's gone. So when they go out and they engage in their mock dog fights, they set a hard floor of say, 10,000 feet. And in the mock dog fights, if a plane pierces the 10,000-foot altitude level, he's deemed to have pancaked into the ground and been destroyed.

But the reality is there's no consequence because it's not a real hard ceiling. You go below

10,000 feet, you blew it. You fly the next day, and try and figure out how to win the mock combat without going below 10,000 feet and then you win. And I sort of view that retained earnings minimum a little bit like the hard 10,000-foot floor when you doing mock dog fights in a training program.

You should be able to pierce the retained earnings minimum without triggering a crisis. Hopefully, if we get the number right, you're not going to impel the par value of your stock. And if you get the number right, you shouldn't precipitate any other crises like being able to repurchase or redeem stock or being able to pay dividends.

And so I do have a concern that the way the post-transition is described, it makes it look like if you pierce that ceiling, it's an event that will participate a crisis that unlike what would happen if you were in danger of periling the par value of your stock. You can't pay dividends without Finance Board approval, and I sort of would like your thoughts on that.

DR. CROSS: Well, I think that your "Top Gun" analogy is a good one. I'd modify it slightly and say that if in a dog fight you pierce the 10,000 foot floor and you're immediately engaged in another dog fight, you should get above that 10,000-foot floor before you start engaging in that dog fight again because once you're below it, if you're then engaged in a dog fight, you are closer to the catastrophe. That's one point.

The second point is that again, the limit is not a hard limit. It is a limit of don't pay dividends without the prior approval of the Finance Board.

Our thinking about this is very simple. We're distinguishing between a transition period from, as you suggest, one regime to a different regime and giving some time and expecting dividends be paid during that period of time with a circumstance of remediation in which the bank has fallen below the floor.

Our expectation is that that will occur and occur in an order of magnitude that it is not

overcome by the earnings in the current quarter, only if a bank loses money and is either losing money in consecutive quarters or has lost a lot of money. In the case in which a bank has lost a lot of money, we think that the prudent approach to take is to say, okay, before you pay dividends, let's jointly understand the circumstances that gave rise to your losses and the correctives in place. It's what we have done in the past with banks that have experienced losses.

We have established on an informal supervisory basis some limits as to what they can and cannot do. In the case that the Chairman referenced in his opening remarks where New York quickly addressed the problems of its asset-backed securities portfolio or triple A portfolio when they purchased it but that had losses in market value that were realized when the portfolio was sold, that bank didn't pay dividends for a couple of quarters and then slowly began paying dividends again.

Our thinking is very simply that if we're talking about a small little blip that brings the

bank to 8,000 feet or 9,000 feet, they can come to us and say, this was a small blip. It would be counter-productive for us to pay zero dividends. We will get up to 10,000 feet in the next two quarters, even if we pay a 50% dividend or 40% or 70% dividend. And we would be willing to consider that analysis.

My concern is that if we establish that if you fall below in a remediation circumstance and we put in the rule that you may pay 50% without the approval of the Finance Board, you might get a severe circumstance in which a 50% dividend would not be appropriate and our ability to limit dividends in those circumstances, while probably existing because of our overwhelming authority under the safety and soundness provisions of the statute would be, I think, weaker. So that's why we proposed to --

DIRECTOR MENDELOWITZ: I find that a very convincing argument. I think that if I understood you correctly, if a bank has a spurious accounting loss, you would view that as fairly benign because

basically, these spurious accounting losses are a result of timing. You could wind up with a big loss on the end of your quarter and make it all back in the next month. And if that's the case made, then you view that as benign.

If it's a one-time loss, you'd look at it from the perspective of what needs to be done over a reasonable time period to rebuild the retained earnings. If there is a systemic problem at the bank which means there's policy problems, there are procedural problems, there are balance sheet problems, then you'd take a much more restrictive view toward the appropriate dividend payout, and I think that's a perfectly reasonable and, from my perspective, comforting approach as to how you would do it.

I just have one or two quick questions that remain. The proposal is written on the assumption that dividends will be paid out of current quarter income and I'm happy to see that you actually have to close the books on the quarter and know what your income is before you can declare a dividend.

I mean one of the things that has troubled me was banks that were declaring dividends before they knew what their income was, so I really liked that. But some banks actually have been proactive in dealing with the problem of -- that it's not appropriate to pay dividends before you know what your income is. And what they've done is they've lagged their dividends and so they either pay a dividend at the end of Q-1 based upon the income in Q-4 or they pay a dividend in Q-1 based upon say, one month from Q-4 and the first two months of Q-1. And the question I have is is that considered appropriate under this proposed rule?

DR. CROSS: I haven't spoken to Tom about that specifically, but my understanding is, yes, that certainly the first clearly is appropriate.

The second, because the banks prepare monthly income statements and balance sheets, they would have recorded income. So unless I'm corrected by someone else at the table, I understood both circumstances to be permissible under the proposal.

MR. JOSEPH: The proposal specifically requires them to meet their retained earnings as of the last day of the quarter or so. They could pay it based on that income, I guess, though the REM would be calculated as of the end of the previous quarter and they would have to -- total dividend -- well, no, because the total dividend, once it's subtracted from current net earnings from the previous quarter, it would still -- you'd have to meet your REM. So I don't think the second situation, given the rule as it's written now, would be possible. I don't think you could do it.

DIRECTOR MENDELOWITZ: Well, I'd like to get comments from respondents as to how we can accommodate different ways in which the banks may decide how they're going to implement the appropriate approach to dividend which is only out of closed books, whether it'd be from a previous quarter or a partial quarter. And if they do it and we can reconcile all the moving parts here, I'd like to hear your comments.

I have one last question and I'll relinquish the floor. One of the roles that retained earnings play is dividend stabilization. And under the proposed rule, it doesn't appear to me that the required minimum in fact could play the dividend stabilization role because all sorts of things come into play if you fall below it.

If you have a bank which, for example, has the required minimum plus a little bit on top and it suffers what is a purely spurious accounting loss because of timing associated with FAS-133 and the other side of market issues, would you view it appropriate to dip below the required minimum at the end of a quarter to pay a dividend with the understanding that it would be replaced within a month or two because of the accounting issues?

DR. CROSS: I'm trying to sort through exactly how this would work but again, as with the earlier question, my initial reaction is that in the case of accounting-induced volatility that, as we've seen in some cases in the past, is being reversed, maybe even reversed by the time the dividend

decision would be made. We would have to take that into account. The bank would have to make the case, but I certainly would be open to having that case made.

That said, I will say that from our perspective, that there should be some consequence to falling below the minimum, that it is designed -- it's characterized as retained earnings minimum, not retained earnings target.

And just like there are consequences from falling below the minimum capital requirement and banks typically, where the minimum 4% capital requirement, will operate with 4.2 or 4.4 or 4.5%, there is an argument that the banks should not view this as a floor and a ceiling, but rather as a floor.

That said, the idea of permitting an out with Finance Board approval is designed to deal with cases such as these where the results are spurious, temporary and self-correcting.

DIRECTOR MENDELOWITZ: Great. Now, I really want to thank the staff for all the work

they've done on this proposal. And I want to thank you for bearing with my long set of questions and helping me understand better where all the implications and the provisions of the proposed rule are and the areas where we're looking to get comments from respondents.

You've really done an outstanding job of putting a reasonable proposal together and explaining it in which I think is a very clear and very intuitive way. And I hope that this exchange in these questions and your explications on what the intent is and what the provisions are will prove particularly useful to those folks who are watching the Board meeting by the webcast, and have a very, very serious interest in this matter. Thank you.

CHAIRMAN ROSENFELD: Thank you, Director Mendelowitz. I would point out to our guests here today that today's meeting is not intended to compensate for our four-minute meeting a few months ago. It's merely a reflection of the significance of what's being proposed here today. Any other comments?

DIRECTOR CASTANEDA: Franz, you have any comments?

DIRECTOR LEICHTER: Go on, you go.

DIRECTOR CASTANEDA: Well, I think Director Mendelowitz raised a very interesting issues. But in general, I think I would like to say that based on my conversations with all of the other Directors, I think there is a broad consensus on this Board for the idea that the Home Loan Bank should one, reduce the reliance on excess stock, and two, in light of the unique nature and limits of Home Loan Bank stock, as a general matter, increase retained earnings available to caution unanticipated losses.

As for the specifics of the proposal the staff has been working on and which the Chairman has put before us today, I'm sure this will generate a lot of interest through the system, and we will be receiving a lot of feedback from interested parties.

I know I'm going to be looking forward to seeing the comments people have on how the Finance Board can get this right. That was short.

DIRECTOR MENDELOWITZ: On average, we weren't too long.

CHAIRMAN ROSENFELD: Thank you, Director Castaneda. Director Leichter?

DIRECTOR LEICHTER: Yes. Thank you, Mr. Chairman.

I think this is a very significant and a very beneficial change to the capital structure of the Federal Home Loan Banks. The proposed regulation aims to strengthen the capital structure of the Federal Home Loan Banks and to closely and effectively align and focus the banks' capital with their mission.

Now, I think you can quibble about some of the models and some of the assumptions and some of the analysis, but I don't think that you can object to our main two purposes which is to avoid a build-up to an unreasonable level of excess capital or to require an appropriate level of retained earnings.

I want to commend you, Mr. Chairman, and I want to commend the staff for bringing this proposal before us. I think it might be more comfortable

just to go with the status quo and not to oil the waters, but I think that would be an abdication of our responsibility. I think the steps that we take are appropriate, are really necessary. They're necessary because of two changes in the nature of the bank system in the last few years.

As we've seen, we have two banks under regulatory agreement. If the capital changes that are proposed and these regulations were in effect, these banks never would have found themselves in the situation where a regulatory agreement was necessary.

Secondly, the risk profile of the Federal Home Loan Banks has changed in the last few years. As our last quarterly report shows, the advances now are 62% of all system assets. Mortgages represent 10.5%. MBS represents 12% of all system assets, and non-MBS investments represent 15% of all system assets. There's an additional .5% of other assets. So that comes up to 100%.

That's a very different risk profile than we saw some years ago when the system was

essentially an advance-based system which is as close to riskless as you can get. So I think what the staff has done here is taking into account these changes that we've seen to come up with proposals that do unquestionably strengthen the capital structure of the system.

And I want to say, a lot of work has gone into this. This was not done on the back of an envelope. This is something the staff and the Board of Directors have worked on for many months. A lot of consideration was given on it, and I want to express my thanks to Director Mendelowitz who played a particularly important role in trying to bring us to a more rational capital structure.

And we may quibble or it may not be perfect, but I think what it does achieve is that we will for the benefit of all the members of the system have a much stronger capital structure.

I want to address first the retained earnings because I think Director Mendelowitz's questions were more directed to that. It is clearly

important to have retained earnings in order to cushion losses and stabilize dividend payouts.

In fact, Director Mendelowitz, since he joined the Board at the end of 2000, has been the strongest voice urging that there be an increase in the retained earnings. We did have an Advisory Bulletin which moved the banks towards this, although somewhat slowly.

And I must say, the banks themselves have said, give us a clear formula. Well, we're giving you a clear formula now, and I think it's a reasonable formula. I understand the argument of one size fits all creates some difficulties and may seem on the surface to create some unfairness or difficulties. I think I'm expressing it too strongly, but for some banks, it may not fit as well as for others.

But I think you've got to look at this as a floor and there certainly is flexibility. The risk-based theory certainly makes sense in theory, but it's hard to achieve. And I don't want the good which I think this regulation or proposed regulation

is to become the victim of the perfect. As we've seen in Basel II, it's very hard to come up with a risk-based formula.

So to say to the staff, well, we'd like to have it in nine months or a year, and I'm sure they're going to work on it and will try to come up with something, but I think we ought to realize that it's not something that is that easy to achieve. And in the meantime, it certainly makes sense to reach a level of retained earnings that will give us much more comfort.

And I think it's important to point out, I think Steve Cross pointed it out, but I want to emphasize it, this is not a rigid formula, both in the transition period and in the post-transition period. And I want to address people's attention to Section 934.3, which says that in the transition period where those banks that have not reached their level of retained earnings are limited to 50% of current net earnings, but that is without the prior approval of the Finance Board.

Similarly, if in the post-transition period, a bank, once having achieved the proper level of retained earning, now falls below that level, it may not declare or pay dividends again without the prior approval of the Finance Board. And I think the Finance Board is going to act reasonable and take into consideration all of the factors that you pointed out, Director Mendelowitz, in your questions.

So I think to assure the banks there is flexibility here, and I think if we came up with a rigid formula, and maybe even a risk-based formula would tend to be too rigid, you need to have the sort of flexibility that I think is written into this proposed rule.

As far as the excess capital limitation goes, I think it's very hard for anybody to argue against having some limitation on excess capital. Excess stock is basically unstable and impermanent capital. A higher level of excess stock often leads to investments and assets which are not mission-related and to arbitraging the GSE advantage.

Thus, one of the banks that has a high level of excess stock has 19% of its assets in unsecured investments. I question whether that's appropriate, and certainly, the aim of this proposed regulation is to see that we not have such a high level of unsecured investments.

In my view, the systemwide investment in unsecured assets is frankly inappropriately large, and it's been growing. Comparing the data on total unsecured credit outstanding from the end of December 2004 to the end of December 2005, there's been a 35% increase in unsecured credit systemwide, from \$105 billion in 2004 to \$142 billion in 2005.

As a portion of the total unsecured credit to private counter-parties, this increase was from \$79 billion to \$121 billion was a 53 jump. And it's noticeable that 8 of the large 10 counter-parties are foreign banks. I would say that in limiting the excess stock, we're also aiming to stop a practice which I don't think is wholesome and appropriate for the Federal Home Loan Banks.

The prohibition on members purchasing capital stock, I think, is highly desirable. When we had before us some years ago the Chicago capital plan which was based on what was called voluntary stock, the same as excess stock, I voted against that plan and the business plan upon which it was based. I think that was foreign to the whole tradition and the system and the structure of the Home Loan Banks to go out and to solicit voluntary stock.

This proposed rule will stop that practice and I think will avoid the difficulties that Chicago found itself as a result of following that system.

Let me just say there's going to be a transition period. There's four banks that, as I understand it, will have excess capital beyond the one percent limitation. Two of those fairly close to the one percent limitation should not be a problem. I think for those two banks that will need to have a transition period, this again, will be flexibly and appropriately handled, I believe, by the Office of Supervision. So we have a mechanism

here which will allow for an appropriate and reasonable transition.

As far as the issue of prohibiting stock dividends, we're really interested in getting the comments of the banks. I appreciate the points that were made earlier whether it's necessary to limit all stock dividends as long as you stay within that one percent limitation. And we expect to look very carefully at the comments, and if a good case can be made why the bank should continue to make payments of stock dividends without damaging the capital structure of the banks or their business plan, then I'm sure that this Board will take that into consideration.

So I think overall when you look at what we're doing here, is it perfect? Maybe not. Is it the right direction to go? Is it the right thing to go? Is it something that will better and strengthen the Home Loan Bank system? Will it give more comfort to the members in knowing that their stock is not going to be impaired? Unquestionably, yes.

So I feel that we're making significant progress in bettering the Home Loan Bank system with this proposed regulation. Thank you, Mr. Chairman.

CHAIRMAN ROSENFELD: Thank you, Director Leichter. Director Montgomery?

DIRECTOR MONTGOMERY: Thank you, Mr. Chairman.

As you're aware, one of my other day jobs is that I have a regulatory role at our friends at Fannie and Freddie. However, it relates more to new program approval rather than the capital adequacy side. But I do want to applaud your efforts, Mr. Chairman, and my colleagues, Steve and your staff, for addressing some of the problems I think that excess stock can and I want to stress can cause.

I also want to applaud your efforts in trying to bring some uniformity to the retained earnings standard. And I, too, look forward to the public comments from the banks and from other groups.

CHAIRMAN ROSENFELD: Thank you, Director Montgomery.

I'd like to both acknowledge and applaud the efforts of this Board and the efforts of our staff. I think that the depth of Allan's questions reflect serious thoughts into what is being proposed here today.

I think the responses of Steve Cross to Allan's questions reflect the fact that the Office of Supervision and our legal counsel have certainly thoughtfully considered the important issues that Allan has raised.

I think that all of us take great pride in the fact that we truly do function in my opinion as a very appropriate Board for the challenges that we've been honored to address. Director Leichter, for as long as I have known him, has raised issues about the appropriateness of certain type investments and why the banks do this. I mean these banks were not created -- the system was not created to arbitrage the GSE status. To give a arbitrage is to perform a mission and if an activity is not within that mission, what's the rationale to permit such a thing.

I think his persistence in raising this issue and continuing to speak about it serves us all well. I consider it -- this is an evolving mechanism, this Board. Boards are -- that's their nature. Quite frankly, I think we're getting better. And I think one of the reasons I think we're getting better is evidenced by the fact that we have a great interest in listening, not only to ourselves but listening to the comments of the folks who will now be in a position to see what we're proposing and to respond in the 120-day response period.

So let me assure you, Franz, that we will not hesitate to do something. We will not wait for the perfect. That's probably not attainable, but I think all of us when we leave the position we have will be honestly able to say the Home Loan Bank system is a little better than when we got here.

So that's about as good as it can get. I thank you all for your patience, and certainly, the Directors and staff for your very hard work, and we look forward to finalizing this matter.

Before we conclude, I think we're certainly going to have to vote. And if there's nothing else, I accept the motion to approve the resolution and to allow the staff to make technical and conforming changes to the rule.

DIRECTOR LEICHTER: Yes. I so move.

SECRETARY: On the item before the Board, Director Leichter, how do you vote?

DIRECTOR LEICHTER: Yes.

SECRETARY: Director Castaneda?

DIRECTOR CASTANEDA: Yes.

SECRETARY: Director Mendelowitz?

DIRECTOR MENDELOWITZ: Yes.

SECRETARY: Director Montgomery?

DIRECTOR MONTGOMERY: Yes.

SECRETARY: Chairman Rosenfeld?

CHAIRMAN ROSENFELD: Yes. The motion is adopted, but before we take a ten-minute break, the Board wishes to acknowledge the work of Chris Morton who has been the Board Assistant to Director Leichter. Chris is moving on to a new and hopefully, productive career, certainly a lucrative

career at Fannie Mae, and we want to thank him for his service to our Board and wish him the best of luck.

This ends the --

DIRECTOR LEICHTER: Can I just say one word about Chris Morton, it is obviously a loss not just for me but also for the Board because Chris has been really such a valuable, dedicated, committed and hard-working member of our team. I know that throughout his tenure with me which is almost four years, his aim and his questions to me always were, is it a benefit to the system. And I think his commitment was very important, certainly enabling me to function but I think it was of assistance and help to the Finance Board. So he will be missed, I will certainly miss him. We wish him good luck, and hopefully, it will be lucrative.

CHAIRMAN ROSENFELD: This ends the open session of the meeting. We will reconvene in ten minutes.

(Whereupon, at 11:34 a.m., the open session was adjourned.)

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